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SAVING, INVESTMENT AND GROWTH:
A SMITHIAN PERSPECTIVE

BY

RAMESH CHANDRA

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DEPARTMENT OF ECONOMICS
UNIVERSITY OF STRATHCLYDE
GLASGOW

Saving, Investment and Growth: A Smithian Perspective

Ramesh Chandra
University of Strathclyde, Glasgow, UK
e-mail: ramesh.chandra@strath.ac.uk

Abstract

The role of savings and capital accumulation in growth is widely misunderstood. The emphasis on these factors is often linked to the classical authors, particularly Adam Smith. This paper shows that emphasis on capital accumulation was only one part of the classical message. A more important part was the institutional arrangements which allow a competitive market to function so that savings are utilised in a productive way. The classical emphasis on savings or investment has to be seen in its true perspective and cannot be divorced from the market setting. In this there is much to learn for developing countries in pursuit of growth.
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1. Introduction

Most literature on economic development regards saving and investment as crucial to growth. In simple terms the saving rate may be defined as the proportion of income over and above what a society annually consumes. The higher this surplus of income over consumption, it is often argued, the higher would be the rate of capital accumulation, and thus the higher a society's rate of growth.[1] Lewis (1954, p. 139) captures this idea in the following words: "The central problem in the theory of economic development is to understand the process by which a community which was previously saving and investing four or five per cent of its national income or less, converts itself into an economy where voluntary saving is running at about 12-15% of national income or more." Further:

> All the countries which are now relatively developed have at some time in the past gone through a period of rapid acceleration, in the course of which their rate of annual net investment has moved from 5% or less to 12% or more. That is what we mean by an industrial revolution (Lewis 1955, p. 208).

That capital formation is central to growth emerged as the mainstream view in the post-war period, which besides Lewis had such luminaries as Rosenstein-Rodan (1943, 1961) and Nurkse (1953) among its ranks. The post-war years saw a number of developing countries being granted political freedom and the task of nation building was taken up with zeal. It was argued that low productivity was the key feature of underdeveloped countries and the low use of capital in production was the main cause. So if capital was applied in adequate amounts[2] it could help raise productivity and living standards in the poor countries and magically transform them from a low level equilibrium trap to self-sustaining growth.

In their enthusiasm to grow fast, many of the post-war developing economies followed state-sponsored planning.[3] It was argued that left to itself the market would lead to sub-optimal

[1] Historically, different schools have defined the concept of surplus differently. For example, while the mercantilists thought of the concept in terms of a favourable trade balance, classicists defined it in terms of net revenue or that part of gross revenue which was left after providing for the maintenance requirements (of the fixed and circulating capital) of the society.
[2] In his theory of the "big-push" Rosenstein-Rodan (1943, 1961) pointed out that the size of the investment programme had to be sufficiently big to launch an economy into self-sustaining growth.
[3] The rationale for planning was advocated by such authors as Rosenstein-Rodan (1943, 1961) and Myrdal (1957). While Rosenstein-Rodan emphasised the need to co-ordinate investment activity through some sort of

saving and investment rates.[4] State intervention included measures not only to push up the rates of savings and investment through interference in the market, but also measures to engineer an economic take-off through public-sector investments in an inward-oriented framework.[5] A more direct role for the government implied coercive efforts to mobilise public resources through such means as high and progressive taxation, money-financed deficits, and financial repression. Indeed, it can be argued that many of the post-war development policies were akin to mercantilism which Adam Smith (1776) attacked. Excessive tariff and non-tariff protection to domestic industries and high inward-orientation of the policy framework meant discrimination against agriculture and exports.[6] Because the policies had an in-built bias against exports, exports were sought to be encouraged through such bureaucratic measures as subsidies, duty exemptions or drawbacks. Often such schemes lacked transparency and were open to abuse or discretion. Over time an elaborate apparatus of favouritism and privileges was built up. The command and control mechanisms built up by the state to take allocation decisions encouraged rent-seeking behaviour (see, for example, Bhagwati,1982 and Krueger, 1974). To curb consumption, especially the luxuries, heavy taxation was resorted to. Many of these policies were justified in the name of market failure, but in fact led to widespread government failure.[7]

The origins of the argument that saving and capital accumulation lie at the heart of growth were often traced back to classical economists such as Smith. For example, in his famous model of growth with unlimited supplies of labour Lewis (1954) employed a classical saving function in which savings for growth come out of the capitalists' profits. Even Romer (1986) invoked Smith's famous pin-factory example to argue the importance of "fixed costs" in reaping the economies of scale. In his streamlined presentation of the "big push" model based on Murphy et al. (1989), Krugman (1993) emphasises the key role played by economies of scale, which presupposes the crucial role of capital.[8]

To be sure Smith (1776) did state that the annual produce of a country had a close link with the capital employed in the production process (*WN*, I, p.365). He also stated that capitals are increased by parsimony and diminished by prodigality and misconduct (*ibid*., I, 358). He even went to the extent of branding every frugal man a public friend and each prodigal a public enemy. Each individual had an inborn desire to better his condition, and this is what prompted him to save:

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planning or investment board, Myrdal advocated an interventionist state in a planned framework to correct the inequalities arising out of the process of circular cumulative causation.

[4] See Rosenstein-Rodan (1955) on the role of programming in maximising the amount and in optimising the composition of investment.

[5] The famous Prebisch (1950)-Singer (1950) hypothesis on a secular decline in the terms of trade for primary producing countries made a case for import-substitution led growth, as export prospects of these countries were thought to be bleak. Similarly Nurkse (1962) argued that although trade had worked as an engine of growth in the earlier century, it was unavailable to contemporary developing countries because of the slowdown in world trade.

[6] For the ill effects of excessive import substitution policies see Balassa (1980). He argues that it was not import substitution per se but excessive (or second stage) import substitution which had perverse effects.

[7] An interesting account of government failure in India is provided by Bardhan (1984). In his incisive analysis of the proprietary classes in India, when no single class is dominant, "one predictable outcome is the proliferation of subsidies and grants to placate all of them, with the consequent reduction in available surplus for public capital formation" (p.61).

[8] Although referring to Young (1928), who built on Smith (1776), Krugman forgot that Young regarded economies of scale only incidental to the broader (or macroeconomic) phenomenon of increasing returns. Moreover, Young did not emphasise the role of inputs or inventions in the industrial revolution but the prior increase in the size of the market which made the various inventions and changes in the productive organisation possible (see Chandra, 2003).

> But the principle which prompts to save, is the desire of bettering our condition, a desire which, though generally calm and dispassionate, comes with us from the womb, and never leaves us till we go to the grave (*ibid*., I, pp.362-3).

However, Smith did not say that saving and investment rates need to be boosted by interfering in the market mechanism. He also did not say that state direction to economic activity would lead to better deployment of a country's saving or capital. On the contrary, he argued that any state direction to the economy, for example by protecting an industry, would create monopolies at home and divert resources from more productive uses to less. This would make the national income less than what it would otherwise be; and this in turn would have a deleterious effect on saving and investment rates. He argued that the saving rate would itself be maximised by adhering to the market process. Thus intervention in the market mechanism would compromise the rate of wealth creation or growth. That is precisely why Smith attacked mercantilist policies of interference in trade and the parasitic state apparatus they spawned. Such policies led to unproductive use of a country's precious surplus rather than its productive deployment.

Even the new growth theory, which took off with Romer (1986, 1987) and Lucas (1988) reemphasises the role of saving and capital accumulation in growth. In this theory technical change is made endogenous[9] by making the production function yield increasing returns to scale rather than the neoclassical constant returns to scale. The result is that the contribution of inputs such as capital to growth is greater than in the conventional neoclassical models. Further, the ability of firms to devote more resources to new research[10] is linked to some form of market power. In this context the role of such factors as patents, monopolistic competition and protectionism in making possible increased resources for new research are emphasised.

While growth-accounting exercises based on the neoclassical theory sometimes found a relatively minor role of capital accumulation in growth, the new growth theory reestablished the importance of saving in so far as it is spent on human capital accumulation and new research. Indeed new growth theory reemphasises the role of saving through the link between market power and the generation of resources.

Thus there appears to be a widespread misunderstanding on the exact role of savings in growth. The objective of this paper is to examine the role of saving and capital accumulation from the Smithian perspective in the hope that it will help in understanding the role of saving in its true perspective. It will be argued that emphasis on saving or investment alone will not enable an economy to grow fast unless the conditions required for its efficient use are also simultaneously provided. Emphasis on saving and investment is but one part of the classical message. A more important part is the need for proper institutional arrangements which allow a productive deployment of savings. These arrangements have to allow security to private property and liberty to individuals to pursue their interests their own way. They also have to ensure a competitive market system in which various kinds of privileges and restraints have

[9] In the neoclassical growth accounting exercises pioneered by Solow (1956, 1957) and Abramovitz (1956), per capita income growth is largely due to the "unexplained" residual which is termed "exogenous technical progress". Thus growth is largely the outcome of exogenous factors; factors such as capital accumulation do not have much of a role except in the short run. In the long run it is technical change which drives growth and leads to constant shifts in the production function itself.

[10] Sandilands (2000) questions the emphasis on "new" research in the endogenous growth literature in comparison to the wider diffusion of "existing" knowledge in response to an increase in the market size, in the Youngian theory of increasing returns. See also Chandra (2003), and Chandra and Sandilands (forthcoming).

little place. "Every man, as long as he does not violate the laws of justice, is left perfectly free to pursue his own interest his own way, and bring forth his industry and capital into competition with those of any other man, or order of men" (*WN*, II, 208).

The paper is structured as follows. In the next section we examine Smith's views on savings, capital accumulation and growth. For a thorough examination of this theme, we shall first take up the role of self interest and its link with savings in the Smithian system; secondly, the role of the division of labour and its relationship with capital accumulation; and finally, the institutional arrangements conducive to growth. In section 3 we present our conclusions.

2. Smith on Savings, Accumulation and Growth

2.1 The Role of Self Interest

In the *Wealth of Nations*, Smith (1776) stated: "It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest" (*WN* , I, p.18). However, self-interest of man is not necessarily a bad thing. Smith realised that man's self-love could easily be turned to society's advantage. If each individual is allowed to take care of his own interest, the "invisible hand" produces an outcome which is best suited to the interests of the society.

Man consumes many things in his daily life, which he can only obtain by exchanging a surplus part of his produce with that of others. So he constantly needs the co-operation and assistance of others. To get the co-operation of others, man has to appeal to their self-love, rather than to their benevolence: "We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages" (*ibid.,* I, p.18). In Smith's view if each man acting out of self-interest participates in a mutually beneficial market exchange, it could be a "win-win" situation.[11] So self-interest need not necessarily be viewed in a dim light. Self-love at the individual level is easily converted into social co-operation (or "mutual sympathy") through the process of market exchange.

Smith wanted people to live a dignified life. He stated: "Nobody but a beggar chuses to depend chiefly upon the benevolence of his fellow-citizens" (*ibid*., I, p.18). So self-interest is ultimately about self-respect. If man wants to live with self-respect there is no other way but to specialise in some trade or art and participate in market exchange. It is in this way that we become socially useful. It is through this process that "we obtain from one another the greater part of those mutual good offices which we stand in need of" (*ibid*., I, p.19).

Because of his self-love each man is constantly engaged in bettering his condition. It is the desire of economic betterment that prompts man to save and be parsimonious. As noted, this desire is inborn and stays with us throughout life. The desire to seek economic advancement is so strong that it is ultimately this which propels a man to riches and prosperity. Our bodily needs are easily satisfied. It is from the desire to get recognition and approval from fellow-citizens that man seeks to become rich. "An augmentation of fortune is the means by which the greater part of men propose and wish to better their condition. It is the means the most

[11] In this regard Wilson (1976) observes: "Smith's concern with results and motives led him to recognize that all may gain from activities in which the various participants are guided only by self-interest. For it is a matter of empirical observation that both sides may benefit from a freely negotiated bargain and it is quite wrong to suppose – as is so often done today – that when someone gains, then someone else must lose. Economic activity is not a zero-sum game, although there may be a deeply rooted inclination… to suppose that this is so" (p.77).

vulgar and the most obvious; and the most likely way of augmenting their fortune, is to save and accumulate some part of what they acquire, either regularly and annually, or upon some extraordinary occasions" (*ibid*., I, p. 363).

The natural effort of man to seek economic betterment is such a powerful motive that it propels not only him but the whole society to wealth and riches. When the state allows each individual the liberty to pursue "his own interest his own way" (subject, of course, to the laws of justice) and provides a secure climate to the accumulation of private property, the motive to seek economic improvement receives an added boost. Smith writes:

> The natural effort of every individual to better his own condition, when suffered to exert itself with freedom and security, is so powerful a principle, that it is alone, and without any assistance, not only capable of carrying on the society to wealth and prosperity, but of surmounting a hundred impertinent obstructions with which the folly of human laws too often encumbers its operations: though the effect of these obstructions is always more or less either to encroach upon its freedom, or to diminish its security" (*WN*, II, 49-50).

Therefore, the governments were advised not to create hurdles in the path of individuals engaged in self-interest. On the contrary, they would do a great favour by letting the market forces operate. Since each individual was the best judge of his own self interest he should be left free to pursue it:

> What is the species of industry which his capital can employ, and of which the produce is likely to be of the greatest value, every individual, it is evident, can, in his local situation, judge much better than any statesman or lawgiver can do for him. The statesman, who should attempt to direct private people in what manner they ought to employ their capitals, would not only load himself with a most unnecessary attention, but assume an authority which could safely be trusted, not only to no single person, but to no council or senate whatever, and which would no-where be so dangerous as in the hands of a man who had folly and presumption enough to fancy himself fit enough to exercise it. (*ibid*., I, p. 478).

Smith was a strong opponent of the mercantilist policy of protecting domestic industry or of prohibiting or restricting imports. Such policies of directing the course of economic activity bred monopolies at home and were generally hurtful to the economy. "If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it from them with some part of the produce of our own industry, employed in a way in which we have some advantage" (*ibid*., I, pp. 478-9). The chief flaw of the mercantile system, Smith pointed out, was that the interest of the consumer is almost always sacrificed to that of the consumer, and it regards production (and not consumption) as the ultimate objective of all industry and commerce. Smith thought that this was absurd because consumption should be the end of all production. All restrictions on imports, bounties on exports and encouragement to domestic industries arose because of this misunderstanding. In Great Britain this system went to absurd lengths to put an end to "troublesome competition" from rival nations.[12] For example, it prohibited the exports of instruments of trade. Any artificer who goes abroad to instruct foreigners to teach his trade can be ordered to return home within six months failing which he was treated as an "alien" and forfeited to the king all his land and property. Smith also pointed out that since it were the merchants and the manufacturers who benefited from this system, they were its principal architects and had a vested interest in perpetuating it.

[12] For Smith the wealth of a neighbouring nation was not to be treated as a disadvantage but an advantage in trade: "As a rich man is likely to be a better customer to the industrious people in his neighbourhood, than a poor, so is likewise a rich nation" (*WN*, I, p.520). For this reason commerce of Britain and France, if unrestrained, would be more useful to each other than trade with North America.

Moreover, any artificial direction will end up in diminishing the revenue of a society, its ability to save and the pace of capital accumulation: "The industry of the society can augment only in proportion as its capital augments, and its capital can augment only in proportion to what can be gradually saved out of its revenue. But the immediate effect of every such regulation is to diminish its revenue, and what diminishes its revenue is certainly not very likely to augment its capital faster than it would have augmented of its own accord, had both capital and industry been left to find out their natural employments" (*ibid*., II, p. 479).

It is important to realise that Smith advocated self-interest not as an end in itself but as a means to promote public interest. Therefore he was often critical of unregulated private interests which were opposed to the greater good. For example, Smith was sceptical of the merchant and business classes who suffered from the "wretched spirit of monopoly": "People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices" (*ibid*., I, p.144). The state should therefore do nothing to facilitate such assemblies as by registration of traders, by the establishment of welfare funds by trades for the poor, the sick, the widows, or the orphans, or by incorporation.[13] Similarly any new proposal of law or regulation coming from the business or manufacturing classes should be examined with the most scrupulous and suspicious attention since: "It comes from an order of men, whose interest is never exactly the same with the public, and who accordingly have, upon many occasions, both deceived and oppressed it" (*ibid*., I, p.278).

2.2 The Division of Labour

In Smith, the opulence or prosperity of a country depends on two factors: (1) the skill, dexterity, and judgement with which its labour is generally applied; and (2) on the proportion of productive to unproductive labour. Whether a nation is better or worse supplied with all the necessaries and conveniences of life depends more on the former than on the latter. In this scheme therefore the division of labour (or what is the same thing as productive powers of labour) emerges as the major explanation of economic progress. Indeed the difference between the savage nations of hunters and the civilised and thriving nations is the difference with respect to their levels of the division of labour. While poverty and disease predominated in the former, prosperity and abundance would characterise the latter (*ibid*., I, p. 2).

Smith argued that the division of labour is constrained by the size of the market: "As it is the power of exchanging that gives occasion to the division of labour, so the extent of this division must always be limited by the extent of that power, or, in other words, by the extent of the market" (*ibid*., I, p.21). According to Smith, as exemplified in his now famous pin factory example, the dramatic increase in productivity resulting from the division of labour was "first to the increase in dexterity in every particular workman; secondly, to the saving of time which is commonly lost in passing from one species of work to another; and lastly, to the invention of a great number of machines which facilitate and abridge labour, and enable one man to do the work of many" (*ibid*., I, p.11).

So dominant is the role of the division of labour in Smith's analysis of growth that Schumpeter (1954) remarked: "With A. Smith it is practically the only factor in economic progress" (p. 187). However, Smith did not explore the full implications of the concept. He thought of division of labour largely in terms of job specialisation within a firm or specialised

[13] Welfare activities of the business classes, on the face value, appear harmless. This only shows Smith's scepticism of these classes who, because of their "monopoly spirit", have an interest to oppress the public.

crafts. It was left to Young (1928) to explore its further implications.[14] In Young's view increasing returns largely occur when firms and industries become increasingly specialised in response to increase in the market size. As the market expands a large number of specialised undertakings and industries are created. The process mainly takes the form of industrial differentiation rather than integration.

Viewed thus increasing returns are macroeconomic rather than microeconomic and their presence need not lead to a breakdown of competition, as some economists suggested.[15] For Young competition and increasing returns were perfectly compatible, for increasing returns, in his view, were not mainly the result of large-scale production or production by large firms. As the market grows a representative firm is likely to lose its identity; and therefore looking for increasing returns through the cost schedules of individual firms was thus not the right approach. He insisted that the chief source of increasing returns is *large production* (at the macro level) rather than *large-scale production* (at the micro level).

In Young increasing returns largely take the form of pecuniary external economies and transmitted in the form of reduced costs and prices. For their effective transmission, a well functioning competitive system is required. Without competitive pressures, their transmission may not be adequate. It may be noted that Young did not emphasise perfect competition in relation to increasing returns; only that more competition is better than less. Young pointed out that different industries grow at different rates depending on the elasticities of demand and supply. These elasticities are in turn crucially linked to competition: the greater the competition, the greater these elasticities are likely to be.

While Smith stated that the division of labour is determined by the extent of the market, Young further developed this insight by arguing that the division of labour depends on the division of labour itself. In this way the process of growth was made endogenous and self-sustaining. It may also be noted that Young did not view capital accumulation as the chief causative factor in growth. Instead, in his demand-based view of growth, inputs of labour and capital are seen more as the consequence of growth than its cause. "Even with a stationary population and in the absence of new discoveries in pure and applied science there are no limits to the process of expansion except the limit beyond which demand is not elastic and returns do not increase" (Young 1928, p. 534).

Even while emphasising the role of capital accumulation, classical economists were careful to bring out its link with the division of labour. For example, in Smith's view, greater capital was necessary to provide workmen with better machinery and instruments which furthered the division of labour. Similarly, more capital was required for a proper division and distribution of employment:

> The productive powers of the same number of labourers cannot be increased, but in consequence either of some addition and improvement to those machines and instruments which facilitate and abridge labour; or of a more proper division and distribution of employment. In either case an additional capital is always required. It is by means of an additional capital only, that the undertaker of any work can either provide his workmen with better machinery, or a more proper distribution of employment among them. When the work to be done consists of a number of parts, to keep every man constantly employed in one way, requires a much greater capital than where every man is occasionally employed in every different part of the work (*WN*, I, pp.364-5).

[14] For a comparative analysis of Smith and Young's contribution on the division of labour, see Chandra (2004).
[15] See for example Sraffa (1926) who suggested that the solution to the presence of increasing returns may lie in the theory of monopoly.

Young (1928) also noted that the principal economies of the division of labour are basically the economies of capitalistic and roundabout methods of production, but that they are limited by the size of the market. "It would be wasteful to furnish a factory with an elaborate equipment of specially constructed jigs, gauges, lathes, drills, presses and conveyors to build a hundred automobiles; it would be better to rely mostly upon tools and machines of standard types, so as to make a relatively larger use of directly-applied and relatively smaller use of indirectly-applied labour. Mr. Ford's methods would be absurdly uneconomical if his output were very small, and would be unprofitable even if his output were what many other manufacturers of automobiles would call large" (Young 1928, p.530). One of Kaldor's stylised facts is that input of capital per worker steadily increases with economic growth.[16]

Smith himself pointed out that the division of labour and capital accumulation advance together. In a rude state of society since there is no division of labour no stock is required to carry out the business of society. As the society advances in the division of labour accumulation of stock becomes necessary. It is therefore clear that the division of labour and capital accumulation go hand in hand. However, since the division of labour is determined by the size of the market, the use of capital in production also is determined by market size. So capital accumulation by itself cannot act as an autonomous engine of growth.[17]

For Smith increasing the size of the market was the key to growth. He emphasised many measures in this regard. Firstly, free trade by increasing the size of the market overcomes the limitation imposed on domestic industries by the narrowness of the domestic market.[18] "By means of it, the narrowness of the home market does not hinder the division of labour in any particular branch of art or manufacture from being carried to the highest perfection. By opening a more extensive market for whatever part of the produce of their labour may exceed the home consumption, it encourages them to improve its productive powers, and to augment its annual produce to the utmost, and thereby to increase the real revenue and wealth of the society" (*WN*, I, p.469). Moreover, free trade promotes competition and keeps local monopolies in check; thus resources of a country are better utilised. According to Smith international trade and domestic economic growth go hand in hand.[19] Secondly, Smith emphasised the role of public investment in transport and communications in increasing the size of the domestic market and in integrating it more fully. However, such investments, in his

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[16] Empirical evidence suggests that there is a strong association between equipment investment and growth (see for example, De Long and Summers, 1991). But high correlation does not imply causality. Using formal causality tests, Blomström et al. (1996) find that fixed investment is an effect rather than a cause of growth. In a recent paper Chandra and Sandilands (2003) find that real investment and real GDP in India are cointegrated but that the causality runs from economic growth to capital accumulation and not the other way. For a similar evidence for the UK, see Chandra and Sandilands (2002).

[17] Currie (1997) presents evidence for the US economy during 1959-92 to suggest "that business finances itself; that is, in the aggregate, the supply of business savings arising from depreciation accounts and retained earnings is consistently larger than the volume of business investment" (p. 424). Moreover, business investment follows economic activity rather preceding it, suggesting that causation runs from GDP to investment only (p.425).

[18] Considerable evidence suggests that more open economies grow faster. See, for example, Dollar (1992) and Edwards (1992, 1998). For a time-series evidence on India see Chandra (2000), and Chandra and Love (forthcoming).

[19] See, for example, Myint (1977) who argues that Smith's theory of international trade is intimately linked with his theory of economic growth. In fact both theories can be seen as two sides of the same coin. Even Marshall observed "that the causes which determine the economic progress of nations belong to the study of international trade."

opinion, should be financed as far as possible from collecting tolls from the beneficiaries so that these services can be provided in a sustainable manner.[20]

2.3 Institutional Arrangements

While the classical writers emphasised the role of savings in the accumulation of capital, the efficient utilisation of savings was at least equally important. Economic progress depended not only on the availability of savings but also on the institutions which made its efficient utilisation possible. Therefore, Barber (1967) writes:

> The availability of a surplus from which capital could be accumulated was… a vital concern. No less important to the successful fostering of economic expansion was the efficient utilisation of this potential. In the diagnosis provided by classical writers, the institutional arrangements of mercantilism were ill suited to this assignment. As they saw matters, regulations and restrictions on the movement of men and goods were shackles to efficiency and growth. They called for a world in which energies of enterprising individuals would be liberated and in which market privileges accorded to those in official favour would be stripped away (pp. 20-1).

The productive deployment of savings thus cannot be seen in isolation from the competitive market structure and the institutions which foster it. Adam Smith in his *Wealth of Nations* took great pains in emphasising the importance of the invisible hand doctrine. Smith argued that each individual in trying to maximise his own advantage unknowingly ends up maximising the society's advantage. By preferring his own advantage, each individual is led by an *invisible hand* to promote an end which was no part of his intention: "By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it. I have never known much good done by those who affected to trade for the public good. It is an affectation, indeed, not very common among merchants, and very few words need be employed in dissuading them from it" (*WN*, I, pp.478-79).

Smith made a deep study of various systems of political economy such as slavery, mercantilism , agricultural systems, and the system of natural liberty. Smith's conclusion was that all systems based on encouragements and restraints retard rather than accelerate the progress of society to real wealth and greatness. By granting privileges and imposing restraints the capital of a society is diverted from more productive uses to less.

For example, Smith regarded manufacturing carried on with slave labour dearer than that carried on by freemen. Moreover, slaves, unlike freemen, had no incentive to be inventive: "Slaves… are seldom inventive; and all the most important improvements, either in machinery, or in the arrangement and distribution of work, which facilitate and abridge labour, have been the discoveries of freemen. Should a slave propose any improvement of this kind, his master would be apt to consider the proposal as the suggestion of laziness, and of a desire to save his own labour at the master's expence. The poor slave, instead of reward, would probably meet with abuse, perhaps with some punishment. In the manufactures carried by slaves, therefore, more labour must generally have been employed to execute the same quantity of work, than in those carried on by freemen. The work of the former must upon that account, generally been dearer than that of the latter" (*ibid*., II, 205).

[20] Smith also stressed the importance of decentralisation in the provision of public services. For example services such as street lightening are better provided by local revenue administered by a local administration than by the general exchequer. So in the provision of public services Smith emphasised two principles: self finance and decentralisation.

Similarly, Smith criticised the agricultural systems for being even more inconsistent than the so-called mercantile system. The mercantile system by restricting imports, and by supporting the less advantageous industry at least promotes that species of industry which it means to promote. The agricultural systems, on the other hand, which seek to promote agriculture, do so by imposing restrictions on manufactures. This only increases their prices, tilting the terms of trade in their favour. Thus resources get diverted towards manufacturing rather than agriculture, contrary to the intentions of this system. Thus Smith concludes: "Those agricultural systems…really and in the end discourage their own favourite species of industry" (*ibid*., II, 208).

So Smith's conclusion was that the system of natural liberty, which comes into being on its own when all preferences and restraints are taken away, is the best from the point of view of growth. "If a nation could not prosper without the enjoyment of perfect liberty and perfect justice there is not in the world a nation which could ever have prospered" (*ibid*., II, 208). The "obvious and simple" system of natural liberty allows individuals to pursue their self-interest their own way provided they do not violate the laws of justice. The state then is left to perform only three main functions: defence, justice and public works, which cannot be left to the private initiative.[21]

Smith emphasises the importance of security in his system of natural liberty. Indeed, he links the provision of security with the evolution of the institution of private property. In a society of hunters, since there is hardly any private property, there is no need felt to protect it. Civil government comes into being once private property as an institution is established. In his "four-stages" theory of society, law and government are first needed in the age of shepherds when the concept of property arises. The primary aim of the government therefore is to protect private property.[22] Smith stressed the importance of security in Britain's relative prosperity. Portugal and Spain, on the other hand, were poor because industry there was neither free nor secure (*ibid*., II, 50).

3. Conclusions

Adam Smith's explanation of growth was in terms of two factors: the nexus between the division of labour and market size; and the proportion of productive to unproductive workers in an economy. It was the former which was more crucial to economic expansion. Capital was essential for furthering the division of labour and for employing productive hands. But since the division of labour was limited by the size of the market, capital by itself could not be regarded as an autonomous engine of growth. Had savings or capital accumulation been the chief explanation of growth there was no need for Smith to talk about the division of labour, its relationship with the size of the market, the importance of free trade in increasing the size of the market, the motive power of self-interest, or the various institutional arrangements to see which was best suited to growth. The role of savings in economic expansion therefore has to be seen with considerable scepticism.

[21] However, Smith was not dogmatic about the proper limits of the state. He advocated self-interest only as a means to promote public interest, and not as an end in itself. Whenever, public interest was compromised or not adequately promoted, Smith favoured intervention which went beyond the usual functions of the government stated above. For example, he favoured public education, particularly to the poor, to counter the ill effects of the division of labour. The state could also promote martial spirit in people by organising military training. He also advocated state intervention to eradicate offensive diseases like leprosy. See also Viner (1928).

[22] See also Raphael (1985) for an elaboration of this point.

Post-war development economists stressed the role of capital accumulation in economic progress. By doing so they displayed a partial understanding of the classical message. A more important part of the classical message was the productive deployment of this surplus. For this to happen a strong and competitive market structure is required. The efficient utilisation of surplus cannot be seen apart from the institutional setting which allows markets to work efficiently and smoothly on the basis of self-interest. While emphasising saving and investment, development economists neglected the role of the market in providing the opportunity for growth. In order to maximise the rate of saving, they ended up advocating policies which curbed the market.

In the post-war period policies of import substitution became popular. Most developing countries instituted some kind of planning mechanism to make resource allocation decisions, as the market was not to be trusted for this task. Excessive state intervention was indeed akin to the mercantilism that the classicists had fought. The control and command mechanisms built up to replace the market, apart from hindering growth, spawned a parasitic system of favouritism and privileges. Market failure, which was the justification for interventionism in the first place, was soon overshadowed by a more serious government failure.

The developing countries of today, apart from their own development experience, can perhaps learn from Smith's analysis. Instead of interfering in the market mechanism, these governments can perhaps concentrate their energies on institution building. Appropriate institutions are needed to ensure competition, to maintain law and order, to provide a fair administration of justice, and to protect private property. Since in Smith the market is seen as the engine of growth, governments need to follow pro-market policies rather than going counter to the market process. They need to strengthen markets where they are weak, and to create markets where they are non-existent. The institutional and legal bases for the markets to function need unstinting support. Institutions have to ensure security and liberty. Once this is done the motive power of self-interest can become a powerful vehicle in the promotion of public interest in the form of growth. The key point is that the "folly of human laws" should not be allowed to come in the way of man seeking to better his condition. Since the size of the market is also an important consideration in Smith, policies to integrate the markets internally and to open them up internationally, and to facilitate the mobility of goods and resources, are also desirable.

The recent trend towards greater liberalisation and openness lends support to the view that a greater role for the market is indispensable to economic growth. Pro-market policies increase the size of the market, increase its competitiveness, enhance the division of labour and allow the savings of a country to be more productively utilised. Emphasising saving, capital accumulation, or "new" research may not carry us far unless the institutional basis for an efficient market process is also simultaneously provided. And, in the development context, that is where the state has an important role to play.

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